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RIOTS OR RESPONSIBILITY: LESSONS FROM SWEDEN

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Is it ordained that when countries approach a fiscal crisis, there is no option but austerity, street protests and riots? At a time when many of the major countries, including the US, UK and Japan, as well as many smaller ones, seem hell-bent on committing financial suicide by piling on unsustainable amounts of debt and “entitlement” obligations, some observers are arguing that democracy itself is incompatible with sustained economic prosperity.

The essential problem is that those in majority within a democracy can vote themselves benefits – most often transfer payments – from the richer and more productive minority, which ultimately ends in economic ruin. The Greeks and Californians are examples of people who have used their democracy to vote themselves benefits which cannot be fulfilled.

The road back from financial excess seems inevitably full of suffering and hardship. Thus it is good to understand that this is not the only way to get out of the trouble. Some four decades ago, Sweden became the global poster child for a rich democratic welfare state that seemed well on its way to spending itself into financial pauper-hood. But before they went over the financial cliff, the Swedes woke up to the disastrous course they had set themselves on and made many necessary corrections.

As a result, Sweden is in far better economic and fiscal shape and has recovered from the recession far faster than most countries. The Swedish economy appears to have grown at a 4 per cent rate in

2010, more than double that of the euro area (1.6 per cent) or the UK (1.2 per cent), and far above the US (2.6 per cent). The unemployment rate in Sweden, while high at 7.8 per cent, is significantly below the euro area's 10.1 per cent and the US's at 9.6 per cent. The Swedish fiscal deficit in 2010 was only a very manageable 1.5 per cent of GDP, compared to a 6.5 per cent for the euro zone, 10.1 per cent for the UK, and 9.2 per cent for the US.

The fall and rise of Sweden

Many European countries now seem to have little choice but to perform agonising austerity measures to avoid the collapse of their economies. But this is not the only path to reform. Sweden serves as a good example of a democratic country that has changed its course in a radical way after being mired in debt and suffering from economic stagnation, while avoiding the street protests.

In the beginning of the 1990s, Sweden was a lost child in the world economy. After gaining political power in the 1930s, the Social Democratic party took on the task of building the Swedish welfare state. The goal was to save its people from all ills. The state would not only protect the citizens from unemployment, but also protect the nation from swings in the economy. At first, classic Keynesian policies were followed – public spending increased in economic downturns and grew more modestly during periods of economic growth. The model seemed to be working fine until the industrial job market declined in the 1960s and 1970s. With the rise in unemployment, the social welfare system expanded rapidly while an ever larger share of the workforce was employed in the public sector.

An economy cannot thrive on government subsidies. For Sweden, that became clear with the oil crisis in the 1970s. By then, the country was notoriously business unfriendly, with both excessive regulation and prohibitively high tax rates.

To "protect" domestic industries in harsh times, huge amounts of tax revenues were wasted on dying sectors, most notably the ship building industry. To keep up with the spending, the maximum marginal income tax rate had reached 87 per cent in 1979. Yet this did not keep the public debt from soaring, which peaked in 1996 at 76 per cent of GDP.

The reversal of the Swedish, socialist/welfare state model started with the deregulation of the financial sector in the 1980s. In the beginning of the 1990s, Sweden suffered a major banking and financial crisis, primarily brought on by mistakes in monetary policy, as well as the continued drag from counterproductive taxing, spending and regulatory policies. This crisis made it apparent for officials of most political colours that the existing Swedish economic model would not be sustainable over the long run.

An observer of the Swedish crisis almost 20 years ago might have anticipated a scenario like the one we saw in Greece in 2010. But, since the early 1990s, Sweden has not only been recovering, but seems to be coming out of the current economic crisis in a much stronger position.

How to get back on track

The globe is littered with examples of countries that have been unwilling to liberalise their economies, cut public spending or deal with the public debt. When a financial crisis strikes, already overburdened and indebted economies are faced with overwhelming problems. Austerity programmes may be put in place to deal with an acute situation, but increasing tax rates, particularly on capital (as many countries have done and continue to do), can severely impede economic revival and growth.

So, is radical reform in a state of panic the only way to go? Sweden presents another model. The reforms Sweden has undertaken are numerous and have been phased in over many years.

The terrible state of the Swedish economy two decades ago led to an implicit agreement on the need for economic liberalization – more choice and lower taxes – and was agreed to by the parties of the right and left. While the socialist parties paid lip service to equality and protection of the needs of the middle class, they contributed to the liberalising reforms as much as right-leaning parties did.

Starting in the 1990s, tax rates were lowered. Numerous government-owned companies were privatised. A voucher system was set up so that any Swedish child could go to the school of his or her choice. The rules for receiving sick benefits were tightened, so that generally healthy people were no longer entitled to unlimited sick time. The pension system was reformed from a pay-as-you-go system to, basically, a defined contribution system, which includes personal funds. The Swedish gift tax, inheritance tax and wealth tax were all abolished during the last decade.

Also, a tightening of unemployment benefits has been instituted.

All of these reforms laid the foundation for a more stable and productive economy, and one that is coming out of the financial crises much less bruised than most of its neighbours'. In 1994, the budget deficit was above 15 per cent of GDP. Today, the figure is close to zero and is expected to turn into a budget surplus next year. The public debt ratio that reached 76 per cent of GDP in 1996 is today a modest, very manageable 36 per cent and expected to fall to 26 per cent in 2013.

As noted earlier, with a current GDP growth rate of 4 per cent, the country is looking pretty healthy compared to the rest of Europe and the US Yields on long-term government bonds have, of late, been close to those of Germany. This indicates that the global financial markets now recognise the stability of Sweden's public finances and its overall economic sound economic management.

Lessons to be learned

The Swedish growth rate is still limited by a partially remaining, overly expansive, welfare system and high tax rates, which, although lower than in the past, are still too high, with still too many remaining labour market rigidities.

Despite these problems, if Sweden had not liberalised its economy, it would be suffering the fiscal calamities that other European countries now face. The Swedish reform process sends a message to other countries that are experiencing an ever growing public sector and over-regulation. Politicians of both the left and right must confess that impossible promises were made to citizens and businesses by government officials to protect them forever from all harm.

But the Swedish experience shows that, if politicians of all stripes agree to work together, put on their pragmatic gloves and begin the reform before the next crisis comes along, disaster can be avoided. Reform does not have to be accomplished in one stroke. It is the direction that is important. If the economy is becoming freer, with less tax, spending and regulatory burdens, participants in the global financial markets will respond positively, making further reforms all that much easier and more attractive.

SWEDEN'S NON-CONSOLIDATED CENTRAL GOVERNMENT DEBT

(percentage of GDP)